Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Caballero	Analyst:	Jahna Alvarado	Bill Number:	AB 829
Related Bills:	See Legislative History	Telephone:	845-5683	Amended Date:	April 14, 2009
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Manufacturers' Investment Credit/Sales Tax Reimbursement Or Use Tax Paid For Tangible Personal Property

SUMMARY

This bill would create a credit for sales or use tax paid on the purchase of tangible property by qualified manufacturers.

This analysis will not address the bill's sales and use tax provision as it does not impact the department or state income tax revenue.

SUMMARY OF AMENDMENTS

The April 14, 2009, amendments replaced the bill language as introduced February 26, 2009, with the proposed credit for sales or use tax paid on the purchase of tangible personal property by qualified manufacturers for transactions occurring between January 1, 2010, and January 1, 2013.

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to promote investment and job growth in the manufacturing sector utilizing a tax credit.

EFFECTIVE/OPERATIVE DATE

As a tax levy, the Personal Income Tax Law (PITL) and Corporation Tax Law (CTL) provisions of this bill would be effective immediately upon enactment. The credit provisions are specifically operative for transactions occurring between January 1, 2010, and January 1, 2013, and is repealed on December 1, 2016.

POSITION

Pending.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Selvi Stanislaus	05/01/09
_______ N	_______ OUA	___X___ PENDING		

ANALYSIS

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

FEDERAL LAW

Existing federal law does not have a credit comparable to that proposed in this bill.

STATE LAW

Previous state law allowed qualified taxpayers a Manufacturers' Investment Credit (MIC) equal to 6 percent of the amount paid or incurred after January 1, 1994, and before January 1, 2004, for qualified property that was placed in service in California.

For purposes of the MIC, a qualified taxpayer was any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property was any of the following:

1) Tangible personal property defined in Section 1245(a) of the Internal Revenue Code (IRC), used in a qualified SIC Code activity, and used primarily for:
   - manufacturing, processing, refining, fabricating, or recycling of property;
   - research and development;
   - maintenance, repair, measurement, or testing of otherwise qualified property; or
   - pollution control that meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) Special purpose buildings and foundations that were an integral part of specified activities.

For taxpayers engaged in computer programming and computer software related activities, qualified property included computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excluded certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process. Additional exclusions are facilities used for warehousing purposes and equipment used to store finished products, after completion of the manufacturing process, including tangible personal property used in administration, general management, or marketing.

The MIC statute was repealed by its own terms and ceased to be operative as of January 1, 2004, due to a reduction in manufacturing sector jobs.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within economic development areas. These incentives include a sales or use tax credit as discussed in greater detail below.

Sales or Use Tax Credit

The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an economic development area (except a Manufacturing Enhancement Area). The amount of the credit is limited to the tax attributable to economic development area income. Qualified property is defined as follows:

Enterprise Zone (EZ) or TTA:

- Machinery and machinery parts used for:
  - manufacturing, processing, assembling, or fabricating;
  - producing renewable energy resources; or
  - air or water pollution control mechanisms.
- Data processing and communication equipment.
- Certain motion picture manufacturing equipment.

LAMBRA:

- High-technology equipment (e.g., computers);
- Aircraft maintenance equipment;
- Aircraft components; or
- Certain depreciable property.

In addition, qualified property must be purchased and placed in service before the economic development area designation expires. The maximum value of property that may be eligible for the EZ, LAMBRA, and TTA sales or use tax credit is $1 million for individuals and $20 million for corporations.

Limitations on Use of Economic Development Area Sales or Use Tax Credit

For businesses operating inside and outside an economic development area, the amount of credit that may be claimed is limited by the amount of tax on income attributable to the economic development area. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor; for taxable years beginning on or after January 1, 2011, certain corporations may elect to use a single factor, 100 percent sales apportionment formula). This income is further apportioned to the economic development area using a two-factor formula based on the property and payroll of the business.

Assignment of Credits between Certain Unitary Affiliates

Corporate taxpayers who are members of a combined reporting group may make a one time, irrevocable assignment of eligible credits, as defined, to an eligible assignee, as defined, in taxable years beginning on or after July 1, 2008. Assigned credits can reduce tax for taxable years beginning on or after January 1, 2010.

<u>THIS BILL</u>

This bill would allow a credit under the PITL in an amount equal to 5 percent of the gross receipts or sales price on purchases of tangible personal property that is:

- used primarily in the manufacturing, processing, refining, fabricating, or recycling of property or is purchased for use by a contractor in a construction project for a qualified person who will use the property as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or
- used as a storage facility used in connection with a manufacturing process.

This bill would allow a credit under the PITL in an amount equal to 6 percent of the gross receipts or sales price on purchases of tangible personal property that is:

- sustainable development equipment investments purchased for use primarily in the manufacturing, processing, refining, fabricating, or recycling of property, or
- used primarily during the research and development process on qualified research.

This bill would allow a credit under the CTL for that portion of sales or use tax paid equal to 6 percent of the gross receipts or sales price on purchases of tangible personal property that is:

- used primarily in the manufacturing, processing, refining, fabricating, or recycling of property or is purchased for use by a contractor in a construction project for a qualified person who will use the property as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or
- used as a storage facility used in connection with a manufacturing process.

This bill would allow a credit under the CTL for that portion of sales or use tax paid equal to 5 percent of the gross receipts or sales price on purchases of tangible personal property that is:

- sustainable development equipment investments purchased for use primarily in the manufacturing, processing, refining, fabricating, or recycling of property, or
- used primarily during the research and development process on qualified research.

The credit allowed under this bill would apply to purchases occurring between January 1, 2010, and January 1, 2013, and would be claimed in three equal amounts over the three successive tax years beginning with the taxable year 2013.

This bill would define a number of terms, including “fabricating,” “manufacturing,” “primarily.” “process,” “processing,” “qualified person,” “qualified research,” “refining,” “sustainable development equipment,” and “tangible personal property.”

This bill would allow any unused credit to be carried forward for a maximum of five years or until exhausted.

There are no limitations or suspension periods under current law that would apply to the credit allowed by this bill.

This credit would be eligible for assignment among members of a unitary group as specified.

This credit would be repealed as of December 1, 2016.

Because this bill does not specify otherwise, this credit would not reduce regular tax below tentative minimum tax (TMT).[1]

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is working with the author’s office to resolve these and other concerns that may be identified.

The department lacks expertise in energy, water, and recycled or reusable resources. Typically, credits involving areas for which the department lacks expertise are certified by another agency or agencies that possess the relevant expertise. The certification language would specify the responsibilities of both the certifying agency and the taxpayer. The taxpayer could then be required to provide this certification to the Franchise Tax Board (FTB) upon request.

This bill uses terms in the PIT and CTL provisions that are sales tax terms, for example, “person,” and “qualified person.” "Taxpayer" and "qualified taxpayer" are the customary terms used within a franchise or income tax credit statute to identify the entity eligible to claim and apply a tax credit against a tax liability. Therefore, those terms have the benefit of past usage and common understanding within the context of a tax credit statute and for consistency and harmony with other tax credit language should be used in this bill. It is recommended that the PIT and CTL provisions be amended to reference terms as defined for franchise and income tax purposes.

This bill uses terms that are undefined, i.e., “integral part” of the manufacturing, processing, refining, fabricating, or recycling process, “reasonable needs,” “recycled or reusable,” ”placed in service,” and “standards established by this state or any local or regional governmental agency within this state.” The absence of definitions or references to federal definitions in this bill to clarify these terms could lead to disputes with taxpayers and would significantly complicate the administration of this credit.

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[1] In the computation of the alternative minimum tax (AMT), various adjustments are made to regular taxable income to arrive at alternative minimum taxable income (AMTI). The minimum tax rate, which can be lower than the regular tax rate, is applied to AMTI to derive the tentative minimum tax (TMT). If the TMT exceeds the regular income tax for that year, the excess is the taxpayer’s AMT for that year. On the other hand, if regular tax exceeds TMT, there is no AMT for that year.

Eligibility for the credit would in part be based on the lines of business “described in” specified sections of the North American Industrial Classification (NAICS) Manual.[2] However, the sections specified in this bill are the four digit Standard Industrial Classification (SIC) sections. Amendments are required to correct this inconsistency. Additionally, the term “engaged in” is unclear and could result in disputes between the department and taxpayers. For example, if a taxpayer that is predominantly engaged in business activities other than manufacturing has a small division engaged in manufacturing, under this bill this taxpayer would be a “qualified person” and, thus, would qualify for the credit on all purchases of tangible personal property used in a business activity totally unrelated to manufacturing. If it is the author’s intent to allow this credit for taxpayers whose principal business activity is classified as manufacturing, the author may wish to amend this bill for clarity.

This bill requires tangible personal property to be purchased during a specified period and “placed in service.” Because “placed in service” is not defined, it is unclear if the credit would be allowed in situations where the property met all of the requirements to qualify for the credit and was removed from service prior to the taxable years the credit would be claimed. This could lead to disputes between the department and taxpayers. The author may wish to amend this bill to clarify the service dates that would qualify for this credit.

Existing law provides tax credits for sales and use taxes paid on manufacturing equipment purchased for use in enterprise zones and program areas. In addition, a tax credit is available for recycling equipment. Nothing in this credit provision prevents a taxpayer from claiming certain multiple credits (i.e., enterprise zone, recycling, and the credit that this bill would allow) for the same qualified property. In addition, the qualified property credit authorized in this bill that a taxpayer could report is unlimited.

This bill fails to limit the number of times a credit may be taken on the same property. This could result in multiple credits on the same property being reported. For example, a qualified purchase is made during the transaction period as defined. If the purchaser resells the property to a “qualified person” at least one year plus one day after the purchase, and before the end of the transaction period, the second sale could also qualify for the credit that would be allowed by this bill. If it is the author’s wish to allow one credit attributable to the purchase of tangible personal property, the author may wish to amend this bill.

This bill would allow contractors who purchase tangible personal property for use in completing a construction contract for a qualified person to claim this credit. This could result in two credits being claimed for the same item, by the contractor and the qualified person. If it is the author’s intent to limit the credit to manufacturers, the author may wish to amend this bill.

This bill would apply the credit in equal installments spread over three taxable years and would allow a carryover of any unused credit. This bill fails to specify the order that the credit and carryover amounts would be applied. The author may wish to amend this bill to add an ordering rule to avoid disputes between taxpayers and the department.

This bill is silent on if this credit would reduce TMT. If it is the author’s intent for this credit to reduce TMT, amendments are necessary.

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[2] Published by the United States Office of Management and Budget, 2007 edition

<u>TECHNICAL CONSIDERATIONS</u>

The credit percentages of 5 percent and 6 percent are reversed in the PIT and CTL provisions. If it is the author's intent for the same credit to apply to both PIT and corporate taxpayers, this bill should be amended for consistency.

The PIT provision references "affiliate" who "is a member of the qualified person's unitary group for which a combined report is required to be filed…" Because this reference would have no effect, it is recommended that this bill be amended to remove the ineffective language.

On page 11, line 31, there is a typographical error. The word "and" should be replaced with "an".

LEGISLATIVE HISTORY

SB 699 (Alquist, 2009/2010) contains the same provisions as this bill and would allow a credit for sales or use tax paid on the purchase of tangible property that is placed in service in the state by qualified manufacturers. SB 699 is scheduled for hearing on May 13, 2009, before the Senate Committee on Revenue and Taxation.

AB 1452 (Committee on Budget, Stats. 2008, Ch. 763) allows a corporate taxpayer that is a member of a combined report to make a one time, irrevocable assignment of certain credits to an affiliated corporation, as defined, for taxable years beginning on or after July 1, 2008. Assigned credits can not reduce tax for taxable years beginning before January 1, 2010.

AB 2076 (Dutton, 2003/2004) would have reinstated the previous MIC only for electric services. AB 2076 failed passage in the Assembly Revenue and Taxation Committee.

AB 1998 (Dutton, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2005, and extended the MIC to activities related to electric service (power generation, transmission, or distribution). AB 1998 failed passage in the Assembly Revenue and Taxation Committee.

AB 2070 (Houston, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2005. AB 2070 failed passage in the Assembly Revenue and Taxation Committee.

SB 1295 (Morrow, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2004, and increased the rate of credit from 6 percent to 8 percent. SB 1295 failed passage in the Senate Revenue and Taxation Committee.

SB 676 (Alquist, Ch. 751, Stats. 1994) made clarifying changes to the MIC, and added provisions allowing the credit for leased property, but only to the lessee.

SB 671 (Alquist, Ch. 881, Stats. 1993) enacted the MIC.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. The survey was limited to income or franchise tax benefits related to manufacturing equipment.

Massachusetts provides a 3 percent credit based on the cost of qualified property used for manufacturing, farming, fishing, or research and development.

New York provides an investment tax credit to manufacturers for certain depreciable equipment or buildings. The credit is 5 percent of up to $350 million of qualified expenditures and 4 percent for qualified expenditures in excess of $350 million. Certified pollution control, industrial waste treatment, and acid rain control facilities also qualify for this credit. Research and development property may qualify for an optional rate of 9 percent.

No comparable credit for *Florida, Illinois, Michigan,* or *Minnesota* was found.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until the implementation concerns have been resolved.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

The revenue loss from this bill would be:

Estimated Revenue Impact of AB 829 Effective for Taxable Years BOA 1/1/2010 Enacted by 6/1/2009 ($ in Millions)					
2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
-$0	-$0	-$0	-$70	-$270	-$385

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact was estimated as follows. First, the amount of qualified manufacturing personal property purchased by corporations was estimated as a fixed percentage of the total capital expenditure of California's manufacturing sector. The fixed percentage of 50 percent was derived from actual data for taxable years 2000 – 2003 as reported by corporations claiming a manufacturing investment credit for these taxable years. This percentage was then applied against the 2006 total capital expenditure for the state, $14.2 billion as reported in the Census Bureau's Survey of Manufactures.[3] For the 2006 taxable year, the amount of qualified expenditures on manufacturing personal property under this bill is approximately $7.1 billion, $14.2 billion total CA capital exp x 50% ≈ $7.1 billion.

The 2006 estimated qualified expenditure amount of $7.1 billion was then extrapolated to later years. The extrapolation was based upon the latest Department of Finance forecast of California's capital expenditures for the manufacturing sector. Due to the forecasted decline in capital expenditures in later years, the extrapolated amount of qualified expenditures in 2010 was estimated to be lower, approximately $6.8 billion.

For purposes of this estimate, it was assumed that 25 percent of this qualified expenditure would be for sustainable development equipment, 10 percent for qualified research, and the remaining 65 percent for qualified personal property. Because taxpayers could delay or accelerate some capital investment to take advantage of the credit allowed by this bill, it was assumed that these decisions would increase qualified expenditures for the 2010 through 2012 tax years by 10 percent. The amount of credit generated under this bill for the 2010 taxable year is approximately $420 million, {[$6.8 billion x (25% + 10%) x 5%] + ($6.8 billion x 65% x 6%)} x 110% ≈ $420 million.

The amount of credit generated for the 2011 and 2012 taxable years, $448 million and $478 million respectively, were estimated in the same manner. Thus the estimated amount of credit available to be claimed in equal amounts over three successive taxable years beginning on or after 1/1/2013 is approximately $1.35 billion, $420 million + $448 million + $478 million ≈ $1.35 billion. Not all of the available credit would be used right away because taxpayers without sufficient tax liability would be unavailable to fully use the generated credit. The unused credit would be carried forward to subsequent years. The amount of generated credit that would be used was simulated using a corporate microsimulation model that is based on a sample of corporate tax returns for the 2006 taxable year. The model calculates tax liabilities based on the corporations' taxable income, net operating losses, stocks of available credits, and enacted tax laws that would affect credit use. The simulation result indicates that under CTL for the 2013 taxable year, approximately 56.6 percent of the generated credit would be used by taxpayers to reduce taxes. The revenue loss attributable to corporations for the 2013 taxable year is approximately $254 million, $1.35 billion x 1/3 x 56.6% ≈ $254 million.

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[3] http://factfinder.census.gov/servlet/IBQTable?_bm=y&-ds_name=AM0631AS101&-geo_id=04000US06&-search_results=01000US&-_lang=en

Next, the revenue losses attributable to PIT taxpayers were added to the corporation results. The PIT revenue impact is assumed to be equal to the average ratio of PIT MIC claimed to corporate MIC claimed for taxable years 2000 - 2003. This ratio is approximately 12 percent. The total PIT and CTL revenue loss for the 2013 taxable year would be approximately $284 million, $254 x (1 + 12%) ≈ $284 million.

The revenue losses for the 2014 and 2015 taxable years were computed using the same methodology.

Finally, the total revenue impact on a taxable-year basis was fiscalized to derive the results on a fiscal-year basis as shown in the table above.

ARGUMENTS/POLICY CONCERNS

This bill would allow taxpayers in certain circumstances to claim multiple tax benefits for the same item of expense. Generally, a credit is allowed in lieu of a deduction in order to eliminate multiple tax benefits for the same item of expense.

This bill fails to limit the amount of the credit that may be taken. Credits that could potentially be quite costly are sometimes limited either on a per-project or per-taxpayer basis.

LEGISLATIVE STAFF CONTACT

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